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SUBJECT: THE GERMAN ECONOMY: MORE GROWTH?

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11. (U) SUMMARY: A rise in German business confidence indexes signaled a change of mood about Germany's economic prospects in early 2006. Many linked the boost to Chancellor Merkel's "honeymoon" effect as business groups put high hopes in the new government and a turnaround from Germany's wan 0.9% growth in 2005. However, the economic fundamentals still suggest Germany's growth will remain relatively modest in 12006. Although Economics Minister Glos informally touts an optimistic 2.0 percent growth, the Government's official growth figure is 1.4 percent; the European Commission projects 1.5 percent. The officially appointed Council of Economic Advisors, a watchdog group of senior German economists, projects Germany will achieve only about 1.0 percent growth because of stagnant wage trends and nearly zero growth in consumer spending. The Merkel coalition awaits a spurt of consumer spending in advance of a looming January 2007 hike in the VAT by 3 percentage points. However, the same VAT's implementation will likely cause a setback in consumer spending, which could slow the German economy in early 2007.

GERMAN GOVERNMENT'S INTERNAL PROJECTIONS

12. (U) Those forecasting stronger 2006 growth rely on projections of robust new plant investment (long delayed) and continued strong performance by German exporters. However, 2005 fourth quarter figures reflect lower plant investment and overall growth than expected. Since Schroeder's announcement of snap national elections in May 2005, a variety of surveys of business and consumer confidence have continued to register sharp increases, with some surveys reaching their highest levels in more than five years. However, despite the optimism, the Economics Ministry's official forecast currently projects Germany's economy will grow by only 1.4 percent in 2006. The Federal Statistical Office issued new numbers at the end of February showing growth in investment in equipment during the third quarter of 2005 was only 1.6 percent, not 3.8 percent as previously thought. Moreover, in the fourth quarter of 2005, equipment investment stagnated, growing only 0.1 percent. This development led to fears that the investment upswing, on which so many hopes had been pinned, might be weaker than expected. In addition, industrial production in Germany actually decreased 0.5 percent in December 2005, while GDP growth slowed to a halt, registering exactly zero in the fourth quarter.

VAT HIKE RISKS 2007 GROWTH

13. (SBU) The Economics Ministry's key forecaster told the Embassy half the growth in 2006 would come from exports and another quarter percentage point will result from consumers' squeezing in big-ticket purchases before a three percent VAT hike goes into effect at the beginning of 2007. The forecaster said private consumption would rise only 0.3 percent in real terms this year, too little to support a strong recovery as real wages, stagnant or worse since 1998, continue to sink. (Wages are projected to decline a further 1.6 percent this year.) The Economics Ministry official said the three percentage point hike in the VAT would have a starkly negative impact on growth in 2007, slowing the economy by 0.75 percent. He noted that the Ministry's internal studies show the economy actually contracting by 0.5 percent in the first quarter of 2007 because of the sharp increase in the VAT. Slightly more optimistic, one of the government's external advisors told the Embassy the VAT hike would shave 0.3 to 0.5 percent off the 2007 growth rate. Other experts have taken a similarly dim view of the VAT hike's impact on growth.

14. (U) Prospects for more domestic demand in 2006 will fall short of creating strong growth. The Economics Ministry foresees the savings rate will sink from 10.6 percent in 2005 to 10.5 percent in 2006, largely because of consumers moving purchases into 2006 to avoid the higher VAT. Income from capital gains and independent employment would rise by 3.6 percent in real terms, according to the Economics Ministry -- the only component of disposable income that would go up in Germany in 2006. But, he noted, this component makes up only 35 percent of total disposable income and would not be enough to fuel a broad recovery. High unemployment continues to contribute to a reluctance of households to consume.

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15. (U) Most economic institutes agree with the government's conservative 1.4% growth projection. In separate Embassy meetings, two members of the Council of Economic Advisors projected continued weak growth. One predicted about 1.6 percent growth this year, followed by a drop-off to about one percent next year because of the VAT increase. The other Council member said he discounted recent optimism and held to the Council's December 2005 forecast of just 1.0% growth in 2006. In February, the European Commission revised upwards its forecast for German growth, from 1.2 percent to 1.5 percent. The Commission's report said growth would be aided by confidence-fueled investment in machinery and equipment, as well as by pre-VAT-hike consumer spending. However, some banks and think tanks have issued more optimistic projections, including Dresdner Bank's 1.8 percent and the 2.1 percent projection released in March by the Institute on the World Economy in Kiel.

16. (SBU) COMMENT: The Government and economic institutes generally base any projections of stronger growth on the eventual positive impact of economic reforms and long delayed domestic investment. These forecasts often interpret recent robust increases in German exports as a necessary harbinger of renewed consumer spending. However, since 2002, these analyses have proved misleading and growth has often been below that predicted. The same risk remains for 2006 projections. Although German exports again appear headed for record levels and some economic reforms are taking hold, it is still too early to bet on overall German economic growth much above 1.4%.

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